

§ 1.1374-7

carryforwards. In 1996, Y's only transaction is the sale of Asset #1 for \$5,000,000. Therefore, Y has net recognized built-in gain in 1996 of \$1,000,000 (\$5,000,000 - \$4,000,000 = \$1,000,000) and a tentative tax under paragraph (a)(3) of § 1.1374-1 of \$350,000 (\$1,000,000 × .35 = \$350,000, assuming a 35 percent tax rate). Also, Y's tentative minimum tax determined under paragraph (b) of this section is \$47,000 [\$5,000,000 - \$4,750,000 = \$250,000 - \$15,000 (corporate exemption amount - \$25,000 phase-out = \$15,000) = \$235,000 × .20 = \$47,000, assuming a 20 percent tax rate]. Thus, Y may use its minimum tax credit in the amount of \$303,000 (\$350,000 - \$47,000 = \$303,000) to offset its section 1374 tentative tax. As a result, Y's section 1374 tax is \$47,000 (\$350,000 - \$303,000 = \$47,000) in 1996 and Y has a minimum tax credit attributable to years for which Y was a C corporation of \$7,000 (\$310,000 - \$303,000 = \$7,000).

[T.D. 8579, 59 FR 66469, Dec. 27, 1994]

§ 1.1374-7 Inventory.

(a) *Valuation.* The fair market value of the inventory of an S corporation on the first day of the recognition period equals the amount that a willing buyer would pay a willing seller for the inventory in a purchase of all the S corporation's assets by a buyer that expects to continue to operate the S corporation's business. For purposes of the preceding sentence, the buyer and seller are presumed not to be under any compulsion to buy or sell and to have reasonable knowledge of all relevant facts.

(b) *Identity of dispositions.* The inventory method used by an S corporation for tax purposes must be used to identify whether the inventory it disposes of during the recognition period is inventory it held on the first day of that period. Thus, a corporation using the LIFO method does not dispose of inventory it held on the first day of the recognition period unless the carrying value of its inventory for a taxable year during that period is less than the carrying value of its inventory on the first day of the recognition period (determined using the LIFO method as described in section 472). However, if a corporation changes its method of accounting for inventory (for example, from the FIFO method to the LIFO method or from the LIFO method to the FIFO method) with a principal purpose of avoiding the tax imposed under

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section 1374, it must use its former method to identify its dispositions of inventory.

[T.D. 8579, 59 FR 66469, Dec. 27, 1994]

§ 1.1374-8 Section 1374(d)(8) transactions.

(a) *In general.* If any S corporation acquires any asset in a transaction in which the S corporation's basis in the asset is determined (in whole or in part) by reference to a C corporation's basis in the assets (or any other property) (a section 1374(d)(8) transaction), section 1374 applies to the net recognized built-in gain attributable to the assets acquired in any section 1374(d)(8) transaction.

(b) *Separate determination of tax.* For purposes of the tax imposed under section 1374(d)(8), a separate determination of tax is made with respect to the assets the S corporation acquires in one section 1374(d)(8) transaction from the assets the S corporation acquires in another section 1374(d)(8) transaction and from the assets the corporation held when it became an S corporation. Thus, an S corporation's section 1374 attributes when it became an S corporation may only be used to reduce the section 1374 tax imposed on dispositions of assets the S corporation held at that time. Similarly, an S corporation's section 1374 attributes acquired in a section 1374(d)(8) transaction may only be used to reduce a section 1374 tax imposed on dispositions of assets the S corporation acquired in the same transaction. If an S corporation makes QSub elections under section 1361(b)(3) for a tiered group of subsidiaries effective on the same day, see § 1.1361-4(b)(2).

(c) *Taxable income limitation.* For purposes of paragraph (a) of this section, an S corporation's taxable income limitation under § 1.1374-2(a)(2) for any taxable year is allocated between or among each of the S corporation's separate determinations of net recognized built-in gain for that year (determined without regard to the taxable income limitation) based on the ratio of each of those determinations to the sum of all of those determinations.

(d) *Examples.* The rules of this section are illustrated by the following examples.

Example 1. Separate determination of tax. (i) X is a C corporation that elected to become an S corporation effective January 1, 1986 (before section 1374 was amended in the Tax Reform Act of 1986). X has a net operating loss carryforward of \$20,000 arising in 1985 when X was a C corporation. On January 1, 1996, Y (an unrelated C corporation) merges into X in a transaction to which section 368(a)(1)(A) applies. Y has no loss carryforwards, credits, or credit carryforwards. The assets X acquired from Y are subject to tax under section 1374 and have a net unrealized built-in gain of \$150,000.

(ii) In 1996, X has a pre-limitation amount of \$50,000 on dispositions of assets acquired from Y and a taxable income limitation of \$100,000 (because only one group of assets is subject to section 1374, there is no allocation of the taxable income limitation). As a result, X has a net recognized built-in gain on those assets of \$50,000. X's \$20,000 net operating loss carryforward may not be used as a deduction against its \$50,000 net recognized built-in gain on the assets X acquired from Y. Therefore, X has a section 1374 tax of \$17,500 ($\$50,000 \times .35 = \$17,500$, assuming a 35 percent tax rate) for its 1996 taxable year.

Example 2. Allocation of taxable income limitation. (i) Y is a C corporation that elects to become an S corporation effective January 1, 1996. The assets Y holds when it becomes an S corporation have a net unrealized built-in gain of \$5,000. Y has no loss carryforwards, credits, or credit carryforwards. On January 1, 1997, Z (an unrelated C corporation) merges into Y in a transaction to which section 368(a)(1)(A) applies. Z has no loss carryforwards, credits, or credit carryforwards. The assets Y acquired from Z are subject to tax under section 1374 and have a net unrealized built-in gain of \$80,000.

(ii) In 1997, Y has a pre-limitation amount on the assets it held when it became an S corporation of \$15,000, a pre-limitation amount on the assets Y acquired from Z of \$15,000, and a taxable income limitation of \$10,000. However, because the assets Y held on becoming an S corporation have a net unrealized built-in gain of \$5,000, its net recognized built-in gain on those assets is limited to \$5,000 before taking into account the taxable income limitation. Y's taxable income limitation of \$10,000 is allocated between the assets Y held on becoming an S corporation and the assets Y acquired from Z for purposes of determining the net recognized built-in gain from each pool of assets. Thus, Y's net recognized built-in gain on the assets Y held on becoming an S corporation is \$2,500 [$\$10,000 \times (\$5,000/\$20,000) = \$2,500$]. Y's net recognized built-in gain on the assets Y acquired from Z is \$7,500 [$\$10,000 \times (\$15,000/\$20,000) = \$7,500$]. Therefore, Y has a section 1374 tax of \$3,500 [$(\$2,500 + \$7,500) \times .35 =$

\$3,500, assuming a 35 percent tax rate] for its 1997 taxable year.

[T.D. 8579, 59 FR 66469, Dec. 27, 1994, as amended by T.D. 8869, 65 FR 3856, Jan. 25, 2000]

§ 1.1374-9 Anti-stuffing rule.

If a corporation acquires an asset before or during the recognition period with a principal purpose of avoiding the tax imposed under section 1374, the asset and any loss, deduction, loss carryforward, credit, or credit carryforward attributable to the asset is disregarded in determining the S corporation's pre-limitation amount, taxable income limitation, net unrealized built-in gain limitation, deductions against net recognized built-in gain, and credits against the section 1374 tax.

[T.D. 8579, 59 FR 66470, Dec. 27, 1994]

§ 1.1374-10 Effective date and additional rules.

(a) *In general.* Sections 1.1374-1 through 1.1374-9 apply for taxable years ending on or after December 27, 1994, but only in cases where the S corporation's return for the taxable year is filed pursuant to an S election or a section 1374(d)(8) transaction occurring on or after December 27, 1994.

(b) *Additional rules.* This paragraph (b) provides rules applicable to certain S corporations, assets, or transactions to which §§ 1.1374-1 through 1.1374-9 do not apply.

(1) *Certain transfers to partnerships.* If a corporation transfers an asset to a partnership in a transaction to which section 721(a) applies and the transfer is made in contemplation of an S election or during the recognition period, section 1374 applies on a disposition of the asset by the partnership as if the S corporation had disposed of the asset itself. This paragraph (b)(1) applies as of the effective date of section 1374, unless the recognition period with respect to the contributed asset is pursuant to an S election or a section 1374(d)(8) transaction occurring on or after December 27, 1994.

(2) *Certain inventory dispositions.* For purposes of section 1374(d)(2)(A), the inventory method used by the taxpayer for tax purposes (FIFO, LIFO, etc.) must be used to identify whether goods